

Quick Takes

September 2011

Quick Takes: “Section 1603 Grants” for Renewable Energy Projects: Take the Money and Run!

Actually, the tag line above should read: “Run, to take the money!” That’s because deadlines are upon us for “Section 1603 grants” under the American Recovery and Reinvestment Act of 2009 (“ARRA”).

And you don’t want to miss out on this grant. It pays 30% (10% in certain cases; see table below) of the costs of “specified energy property” that produces electricity, as follows:

- biomass (closed-loop and open-loop)
- municipal solid waste
- solar
- wind
- geothermal
- marine
- hydrokinetic

The grant is generally not included in your taxable income. Moreover, if your project qualifies for tax-exempt bonds, you can use tax-exempt financing without that causing a reduction in the amount of the grant. *Au contraire* if you elect the production tax credit, instead of the investment tax credit or the Section 1603 grant in lieu of the investment tax credit, under ARRA. This is because the reduction for subsidized energy financing and tax-exempt bond financing still applies to the production tax credit program.

If your renewable energy project won’t be “placed in service” (a term of art) by the end of this year, here’s what you have to do-

1. Before the end of 2011, begin construction (continuously conduct “physical work of a significant nature”, or comply with the “5% safe harbor”) and place the project in service before the applicable “credit termination date” (see table below).
2. Before October 1, 2012, apply to the U.S. Treasury Department (“Treasury”) for the grant (regardless of whether or not the project has been placed in service.)

What’s not to like about this? Nothing, but you should know that: (a) the grant is subject to recapture if the project (*i.e.*, the property) is sold to disqualified persons or ceases to qualify as specified energy

property within 5 years; (b) under the “5% safe harbor”, an independent CPA attestation of the amount incurred is required; and (c) certain persons are not eligible to receive Section 1603 grants (generally, these are federal, state and local governments and their subordinate bodies, tax-exempt organizations like a “501(c)(3) nonprofit”, a “qualified issuer”, such as an electrical co-op, for clean renewable energy bond purposes), and tax pass-through entities like an LLC if any member (or other holder of an equity or profits interest) is ineligible to receive Section 1603 grants.

Under “Deadlines and Guidelines,” below, I give you more information about what this all means.

Treasury doesn’t pay the Section 1603 grant until after the project is placed in service (and all the other requirements are met). If you are the developer and the grant amounts to 30% of the costs of your energy property, how do you fill that 30% gap to get the project built in the first place? In some cases a series of bonds, repayable out of that grant, is sold to bridge that gap. These “bridge bonds” can also be leveraged for purposes of New Markets Tax Credits (“NMTC”), although more structuring is required.

NMTC funding can function like a “forgivable loan” in a leveraged structure (numerous tax considerations apply). This can reduce equity requirements for the project, particularly if a “bridge bonds” are used to bring in the tax credit equity upfront.

So, if you need capital for your renewable energy project, a “Section 1603 grant” can be part of it, but don’t wait. This is particularly true if you are counting on the “5% safe harbor.” In that case, when should you be taking action? Yesterday, probably!

If you need more information, let me know.

Dan

Deadlines and Guidelines

Background. Section 1603 of ARRA allows businesses that place specified energy property in service the option to elect to receive a grant (the “Section 1603 grant”) from Treasury instead of either the production tax credit (IRC Sec. 45) or the investment tax credit. (IRC Sec. 48) Unlike many provisions of the ARRA, the 1603 Grant did not expire at the end of 2010, but is subject to timing requirements described below.

Applications. For property placed in service in 2009, 2010 or 2011, Section 1603 grant applications must be submitted after the property has been placed in service and not later than September 30, 2012. Treasury will review the applications and make payment to qualified applicants within 60 days from the date the completed application is received by Treasury.

For property not placed in service in 2009, 2010 or 2011 but for which construction began in 2009, 2010 or 2011, applications must be submitted after construction commences but not later than September 30, 2012. For property not yet placed in service at the time of the application, Treasury will review such applications and notify the applicant if all eligibility requirements that can be determined prior to the property being placed in service have been met. If so notified, applicants must then submit, within 90 days after the date the property is placed in service, supplemental information sufficient for Treasury to

make a final determination of eligibility. Treasury will conduct a final review of the application at that time and make payment to qualified applicants within 60 days after the supplemental information is received by Treasury. Instructions provided on the application will indicate which portions of the application must be completed at the time the application is initially submitted and which portions must be completed at the time the application is supplemented.

Beginning of Construction. There are two alternative tests for satisfying the requirement of beginning construction before January 1, 2012. Section 1603 provides that construction begins when physical work of a significant nature begins. Alternatively, an applicant may elect the safe harbor described below to determine when construction begins.

Physical Work of a Significant Nature. Physical work of a significant nature means actual physical activity on specified energy property. Purchasing of off-the-shelf equipment will not satisfy this test, because of the required physical activity on specified energy property. Work performed by the taxpayer and by other persons under a written binding contract is taken into account in determining whether construction has begun. Both on-site and off-site work may be taken into account for purposes of demonstrating that physical work of a significant nature has begun. This test does not require a minimum dollar threshold, but does require that the construction be continuous. Treasury will closely scrutinize any construction activity that does not involve a continuous program of construction or a contractual obligation to undertake and complete within a reasonable time, a continuous program of construction. Disruptions in the work schedule that are beyond the applicant’s control (for example, unusual weather or a site at which work can only be performed during certain seasons) will be taken into account in determining whether or not an applicant has undertaken a continuous program of construction.

“5% Safe Harbor”. A safe harbor is provided allowing taxpayers to treat physical work of a significant nature as beginning when the taxpayer incurs or pays more than 5 percent of the total cost of the property (excluding the cost of any land and certain preliminary activities such as site clearing). In the case of property manufactured, constructed, or produced for the taxpayer by another person under a binding written contract that is entered into prior to the manufacture, construction, or production of the property (i) the cost of the property under the contract is treated as paid or incurred when the property is provided to the taxpayer, and (ii) for periods before the property is provided to the taxpayer, costs paid or incurred with respect to the property by such other person are treated as costs of the property that are paid or incurred when paid or incurred by such other person. Merely entering into a contract without paying or incurring project costs will not satisfy the safe harbor.

The United States Department of Treasury has issued a “1603 Begun Construction Checklist”, a copy of which is available as part of this White Paper: “January 2011- “Renewable Energy Tax Credits and Grants”, at <http://danmcrae.info/whitepapers>.

Placed in Service Deadline and Credit Amount. The following chart lists the placed in service deadline and the applicable percentage of eligible cost basis used in computing the payment for each specified energy property.

Specified Energy Property	Credit Termination Date	Applicable Percentage of Eligible Cost Basis
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Large Wind	January 1, 2013	30%
Closed-Loop Biomass Facility	January 1, 2014	30%
Open-loop Biomass Facility	January 1, 2014	30%
Geothermal under Code sec. 45	January 1, 2014	30%
Landfill Gas Facility	January 1, 2014	30%
Trash Facility	January 1, 2014	30%
Qualified Hydropower Facility	January 1, 2014	30%
Marine & Hydrokinetic	January 1, 2014	30%
Solar	January 1, 2017	30%
Geothermal under Code sec. 48	January 1, 2017	10%*
Fuel Cells	January 1, 2017	30%**
Microturbines	January 1, 2017	10%***
Combined Heat & Power	January 1, 2017	10%
Small Wind	January 1, 2017	30%
Geothermal Heat Pumps	January 1, 2017	10%

*Geothermal Property that meets the definitions of qualified property in both § 45 and § 48 is allowed either the 30% credit or the 10% credit but not both.

** For fuel cell property the maximum amount of the payment may not exceed an amount equal to \$1,500 for each 0.5 kilowatt of capacity.

*** For microturbine property the maximum amount of the payment may not exceed an amount equal to \$200 for each kilowatt of capacity.

Use With Tax-Exempt Bonds. A key benefit of the investment tax credit provided by the ARRA is the elimination of the reduction of that tax credit for “subsidized energy financing” (financing provided under a Federal, State, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy) and tax-exempt bonds used to finance a project. The reduction for subsidized energy financing and tax-exempt bond financing remains a component of the production tax credit, and thus should be considered when choosing between the production tax credit, the investment tax credit or the federal grant.

Eligible Applicants. Certain persons are not eligible to receive Section 1603 grants. These include:

- any Federal, state or local government, including any political subdivision, agency or instrumentality thereof;
- any organization that is described in section 501(c) of the Code and is exempt from tax under section 501(a) of the Code;
- any entity referred to in paragraph (4) of section 54(j) of the Code; or
- any partnership or other pass-thru entity, any direct or indirect partner (or other holder of an equity or profits interest) of which is an organization or entity described above unless this person only owns an indirect interest in the applicant through a taxable C corporation.

As long as each direct and indirect partner in the partnership or shareholder or similar interest holder in any other pass-thru entity is eligible to receive a Section 1603 grant, the partnership or pass-thru entity is eligible to receive a Section 1603 grant. Having as a direct or indirect partner, shareholder, or similar interest holder a taxable C corporation any of whose shareholders are not eligible to receive a Section 1603 grant does not affect the eligibility of the partnership or pass-thru entity. Neither a Real Estate Investment Trust, nor a cooperative organization described in section 1381(a) of the Internal Revenue Code is a pass-thru entity for this purpose.

For an applicant to be eligible to receive a Section 1603 grant it must be the owner (or under certain circumstances, the lessee) of the property and must have originally placed the property in service.

Eligible Property. As described above, property eligible to receive Section 1603 grants is “specified energy property.” Specified energy property includes only tangible property (not including a building) that is an integral part of the facility. Specified energy property is property for which depreciation (or amortization in lieu of depreciation) is allowable. Qualified property does not include a building but may include structural components of a building. Property is an integral part of a qualified facility if the property is used directly in the qualified facility and is essential to the completeness of the activity performed in that facility.

In the case of an open loop biomass, closed loop biomass, or municipal solid waste facility, an integral part of the qualified facility may include property used for unloading, transfer, storage, reclaiming from storage, or preparation (shredding, chopping, pulverizing, or screening) of the material to be processed at the plant. If the facility uses a gas or liquid derived from open-loop biomass, closed-loop biomass, or municipal solid waste to produce electricity, equipment used to produce and process such gas or liquid may also be an integral part of the facility. However, equipment used to cultivate closed-loop biomass, equipment used to collect open-loop biomass, closed-loop biomass, or municipal solid waste, and trucks, railroad cars, barges and pipelines that transport open loop biomass, closed loop biomass, or municipal solid waste (or a gas or liquid produced from any of the foregoing) to a qualified facility or between noncontiguous parts of a qualified facility are not an integral part of the facility.

For qualified property that generates electricity, qualified property includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items but does not include any electrical transmission equipment, such as transmission lines and towers, or any equipment beyond the electrical transmission stage, such as transformers and distribution lines.

The original use of the property must begin with the applicant. If the cost of the used parts contained within the property is not more than 20 percent of the total cost of the property (whether acquired or self-constructed), an applicant will not fail to be considered the original user of property because it contains used parts.

Recapture. Proceeds from the Section 1603 grants are not includible in the taxpayer's gross income, but the grant amount is subject to recapture if the property is disposed of to a disqualified person or otherwise ceases to qualify as a specified energy property. A disqualified person is any federal, state, local or tribal government entity, tax-exempt entity, cooperative electric company, clean renewable energy bond lender, or any partnership or other pass-through entity of which one of the above entities is a direct or indirect partner. For recapture purposes, the grant vests ratably over five years.

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General note: This issue of *Quick Takes* is a quick-reference guide for elected and appointed officials, economic developers, community developers, participants in the real estate and financial industries, company executives and managers, and their advisors. The information in this issue is general in nature. Various points that could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

CURRENT BOND RATES	
EFFECTIVE SEPTEMBER 8, 2011	
Interest Rates:	
tax-exempt -	floating: 0.21% fixed: 2.05% <small>(eff. 09/02/11)</small>
Taxable -	floating: 0.45% - 0.50% fixed: 2.29%
General notes: 1. These rates are for the effective date indicated above, or as otherwise indicated. For daily rates, email me at dmcrae@seyfarth.com . 2. These are interest rates on revenue bonds that are variable rate demand bonds; i.e., floating. These can be synthetically fixed via interest rate swaps, as noted below. 3. Tax-exempt rates are for industrial development revenue bonds (IDB's") that are subject to the	

AMT and are 7 day general market quotes.

4. Taxable rates are for taxable IDB's or for taxable "corporate bonds".

5. Fixed rates are for 10 year terms via swaps.

6. All rates are market extracted and approximations, and are not guaranteed.

7. These rates do not reflect all-in costs; e.g., annual letter of credit fees are not included.

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